

Similarly, unlike PBOPs, all businesses that provide pensions are required under IRS/ERISA to fund employee pensions on an accrual basis. This does not apply to PBOPs, because there are no minimum funding requirements. Therefore, it is inappropriate to compare the net present value of pensions to PBOPs.

**8) A FASB Exposure Draft on Taxes Creates
Uncertainty as to SFAS No. 106 Accounting
Costs**

The FASB has issued an Exposure Draft of a proposed Statement of Financial Accounting Standards which would in many respects supercede SFAS No. 96, Accounting for Income Taxes. The Exposure Draft is expected to be adopted by the FASB in early 1992. According to reports in the Wall Street Journal, the proposed rule would ease the impact on profits from SFAS No. 106 by 30% or more.³⁷ Under SFAS No. 96, companies could not offset medical-benefit costs and accruals with future tax credits. The Exposure Draft permits such offsets if taxable profits are expected in the future.³⁸

If SFAS No. 106 is adopted for ratemaking purposes, then the Exposure Draft becomes of crucial importance to this proceeding since it could greatly offset the costs reported under SFAS No. 106. It would be pointless to litigate the relevance and consequences of the Exposure Draft because of its speculative nature. However, once the Exposure Draft is adopted by the FASB, DRA anticipates filing additional testimony. This additional testimony would describe the new accounting standard and explain its relationship to SFAS No. 106.

If the ALJ or Commission chooses to put off the consideration of the new accounting standard, and the Commission adopts SFAS No. 106 for ratemaking, DRA urges the CPUC to make rates subject to refund pending final resolution of issues

37. Wall Street Journal, March 1, 1991; and May 9, 1991.

38. Ibid

relevant to the new accounting standard as it pertains to SFAS No. 106.

9) Conclusion

Adoption of PAYGO accounting for ratemaking is the optimal course of action. This will place ratemaking treatment on the proper and prudent path. Given the uncertainties and inaccuracies attributable to SFAS No. 106, and the reluctance of competitive markets to embrace SFAS No. 106, only PAYGO accounting will protect ratepayer funding, protect employees, and provide this Commission with the flexibility necessary to manage the very explosive, risky, and controversial PBOPs issues. This Commission should assume the same prudent and conservative course that the competitive market is -- fund on a pay-as-you-go basis and continue to monitor as issues and inconsistencies become resolved and as uncertainties are reduced via labor markets, the courts, legislation, retiree benefit markets, health cost containment efforts, and labor/management relations. In addition, this conservative and prudent approach will provide the telecommunications utilities with sufficient discretion to prefund and manage their PBOPs without any Z Factor treatment. DRA's recommendation will reduce the regulatory burden because it will not require reconciliation between GAAP and IRS/ERISA. From a social welfare point of view, the PAYGO accounting is clearly the most cost effective and prudent ratemaking treatment for PBOPs. This Commission, like participants in the nonregulated markets, should focus its scrutiny on cash flows rather than book entries.

DRA continues to maintain its support of PAYGO accounting for ratemaking purposes, because 1) the utilities have not clearly demonstrated that rate recovery for prefunding is cost effective; 2) prefunding has not been embraced by the corporate, legal, and financial communities as the true measure of PBOPs costs; and 3) SFAS No. 106 does not impact cash flow or credit ratings. After careful analysis of all these matters, DRA concludes that the utilities have misunderstood the advantages

and exigency of adopting prefunding -- either limited prefunding or full funding under SFAS No. 106 -- for ratemaking purposes.

2. Justification For Total Revenue Requirements For Prefunding PBOPs

Given the reasons explained in Issue No. 1, above, there is little justification for using SFAS No. 106 to determine funding levels for PBOPs. However, should prefunding PBOPs be adopted and revenue requirements be included in the rates regulated utilities charge their customers, DRA recommends that the following prerequisites be mandated:

1. Utilities must demonstrate that they have diligently pursued and analyzed all available alternatives, including health cost containment and restructuring plans. Ratepayer money should be treated as the precious resource it is and used only as a last resort. This is consistent with economic theory, prudent management, and CPUC precedent (D.89-02-074, pp.8-9).

2. Only those funding vehicles where the contributions are tax-deductible and earnings accumulate tax-free should be authorized. To do otherwise will result in the uneconomic use of ratepayer money. (See Appendix 3.)

3. Shareholders should assume economic responsibility for all risks, penalties, and damages for abuses and/or missed opportunities for which it can be shown were the result of their decisions and actions. Given the uncertainties and risks associated with prefunding PBOPs and the flexibility this Commission is granting utilities for managing these obligations, shareholders and utility management should not be absolved of their responsibility and duty to make prudent decisions and to take reasonable actions.

4. All Utilities must submit, on an annual basis, a complete, official actuarial report for DRA to conduct investigation and discovery in order to determine the fairness and reasonableness of requests for revenues. DRA will be permitted to submit data requests for and the utilities would be required to recalculate the PBOPs revenue requirements.

In making these recommendations, DRA is cognizant that the CPUC has limited authority to prescribe certain arrangements for collectively bargained plans. (See Sections IV. and VII..) More specifically, it may be argued that because of the volatility of PBOPs costs and the unreliability of the actuarial estimates, it is reasonable and, indeed wise, to require proof that the most reasonable and prudent alternative(s) are being pursued, that shareholders assume commensurate risks, that official actuarial reports be filed with the CPUC before rate recovery is granted. To do otherwise would exacerbate rate shock, litigation of PBOPs revenue requirements, and conflicts between labor and management over PBOPs coverage and benefits earned.

3. True-Up of Interim Prefunding Revenue Requirements To Actual Funding Requirements

Should this Commission adopt SFAS No. 106 for ratemaking purposes, then Phase II must address how to incorporate the pre-funded amounts that were allowed in Phase I with what is authorized in Phase II. The true-up calculation is actually a phase-in of what was authorized in Phase I and the funding/nonfunding authorized in Phase II. This phase-in is the result of Phase I's timing and the need to account for the accumulation of assets, resulting from Phase I, in the determination of Phase II revenue requirements. The true-up of interim Phase I pre-funding revenue requirements to Phase II funding requirements depends on 1) the amount of assets accumulated pursuant to Phase I and 2) whether SFAS No. 106 is adopted for ratemaking purposes. If there was excess funding or rejection of SFAS No. 106, then this would result in a refund to ratepayers. Adoption of SFAS No. 106, for ratemaking purposes, should result in an increase to the revenue requirement, but this revenue requirement will be an actuarially determined function of assets accumulated pursuant to Phase I.

In order for DRA and other interested parties to analyze the funding requirements, adequate information must be provided by the utilities because this information is not available to the public. Furthermore, this information must be subject to

investigation and discovery by DRA. DRA recommends that a certified actuarial report be made mandatory because the quality and extent of the information must be safeguarded to protect ratepayers and employees. An actuarial report is required by the IRS to justify tax deductions and the disclosure requirements are well established by the actuarial accounting profession and under IRS/ERISA statutes and GAAP. The certified actuarial report would include disclosure of the actuarial accounting methods, assumptions, use of demographic data, and estimates of the existing liability, accumulated assets and resultant tax-deductible contribution limits. It would also have an attestation by the actuary as to the accuracy of the quantitative valuations, the participants covered, the inclusion of participant contributions, and compliance with IRS statutes and FASB standards. The Commission can use these valuations as reliable and accurate estimates of the tax-deductible funding requirement for PBOPs. These estimates, in turn, can be used to determine the attendant increase in an applicant's revenue requirement. In addition, DRA recommends that the utilities be required to respond to any DRA data requests for the actuary to recalculate the valuation using assumptions and/or other criteria developed by DRA.

4 Procedures To Handle Future Plan Contingencies And Changes To Safeguard Plan Assets And Ratepayers' Interests

One of the most important issues to consider in analyzing accrual accounting is whether or not ratepayer investments are diverted to shareholders or nonregulated entities. For instance, a VEBA (IRC section 501(c)(9)) does not allow for employer reversion, and qualified pension plans under IRS/ERISA do not permit employer reversion without severe penalty. However, some plans, (i.e. 401(h) account), do allow for the reversion of PBOPs' assets or return on assets to employers under certain conditions (see IRS Reg. Sec. 1.401-14(c)(5)). DRA strongly believes that all ratepayer funded PBOPs investments must be protected. This means that all funding vehicles in which assets

can revert back to the employer must be rejected as imprudent. Also, any PBOP investments that involve accounting treatments or funding arrangements which do not completely separate regulated from nonregulated and that do not segregate active employee benefits from PBOPs must not receive rate recovery. Should any events occur which result in the transfer or diversion of PBOPs funding to other uses or nonregulated operations, then ratepayers must be fully compensated. Furthermore, if any changes to plan design and/or coverage have taken place, then DRA and CACD should be informed of this on a timely basis (e.g., within one month of the change).

DRA strongly recommends that the utilities routinely provide DRA and CACD with complete copies of their official actuarial reports. Under IRS/ERISA and GAAP, actuarial reports must address 1) changes and contingencies, 2) funding vehicles, and segregated accounts and operations. DRA would be able to verify that separate trusts and accounts have been established to segregate regulated from nonregulated operations. In addition, complete copies of all trust agreements, amendments to pension plans (i.e., 401(h) accounts) must be provided and company accounting must be explicitly identified and defined before PBOPs funding is authorized. To ensure compliance with these requirements, past ratepayer investments in trusts and accounts which are not clearly segregated should be refunded to ratepayers.

Last, under the New Regulatory Framework (NRF) for Pacific and GTEC, it may not be possible to protect any net ratepayer benefits that may be achievable under SFAS No. 106. This unfortunate situation is due to the fact that any net ratepayer benefits attributable to switching from pay-as-you-go ratemaking to prefunding ratemaking are not expected to materialize for decades and, because of the uncertainties, may not materialize at all (See Appendix 2). Furthermore, under NRF, it is unlikely that any benefits which do materialize would flow through to the ratepayers. Pacific and GTEC are only obligated to share realized benefits to the extent their earnings exceed 13% Rate of Return on Rate Base (ROR), and even then they are obligated to

share only half of the realized benefits. Ratepayers would receive the full benefits only if Pacific and GTEC earnings are in excess of 16% RoR, year after year (a highly unlikely scenario). Thus, the only way to ensure that ratepayers receive the full benefits is to require that any net ratepayer benefits attributable to prefunding flow through into rates (i.e., a reduction) via an annual Z Factor adjustment. The resulting regulatory burden of monitoring PBOPs obligations and revenue requirements on a year-to-year basis for 20 to 40 years into the future would be burdensome and antithetical to the spirit of the New Regulatory Framework.

5. Effects Of Proposed Congressional Legislation Related To PBOPs

There are several areas to consider when analyzing the effects of proposed Congressional legislation related to PBOPs.

The first area is the actuarial accounting treatment for any new legislation which changes the employer's liability. Under SFAS No. 106 and IRS/ERISA accounting, the effect of such legislation is determined by calculating the difference between the cost without the effect of the new legislation and the cost with the new legislation and, then, amortize this differential over five or fifteen years. For the ensuing years, the liability and contribution limits are calculated incorporating the new legislation. Examples of changes in legislation include increases in tax deductibility, changes in the Medical/Medicare program, and fewer tax deductible vehicles.

The second area of consideration relates to the regulatory treatment of the PBOPs and the tax-deductibility of contributions towards PBOPs. For the energy utilities, a case-by-case review would be sufficient to assess the proper ratemaking treatment. For the telecommunication utilities, the Z factor is in place to recognize and deal with any changes in legislation affecting the utilities.

The third area is that an Order Instituting an Investigation might be required in the future, if, for example, increased

federal involvement (vis a vis price controls and socialized medicine) in the health care industry were to be implemented.

6. Potential Sources Of Funding For PBOPS

A. CPUC Standards for Determining Rate Recovery of Funding Alternatives

The primary economic issue concerning prefunding is: "which funding vehicle arrangement maximizes ratepayer benefit?" In this regard, the optimal funding arrangement should result in the achievement of all of the following objectives:

1. Maximizes funding coverage of obligations.
2. Excludes employer reversion.
3. Prevents transfers to nonregulated entities
4. Contributions to it are tax deductible.

This is essential because nontax-deductible arrangements place an unfair burden on ratepayers; and because the net-to-gross multiplier for nontax-deductible contributions eliminates all ratepayer benefits.³⁹

5. Minimizes ratepayer burden.

The primary regulatory issue surrounding funding is: "Have the utilities met established Commission standards of fairness and reasonableness?" In this regard utilities should be required to fullfil the following standard (D.89-02-074, pp.8-9):

39. Net to gross multiplier: An item that cannot be claimed as a tax deduction by a regulated utility requires a revenue requirement "gross up" - approximately 1.67 to each one dollar of cash contribution - to account for the income tax that the utility is incurring due to the item's nontax-deductibility. Thus, prefunding is justified only for those investment vehicles for which contributions are tax-deductible, in order to avoid having ratepayers incur the higher cost of a nontax-deductible contribution.

"[A] reasonable and prudent act is not limited to the optimum act, but includes a spectrum of possible acts Thus, a decision may be found to be reasonable and prudent if the utility shows that its decision making process was sound, that its managers considered a range of possible options in light of information that was or should have been available to them, and that its managers decided on a course of action that fell within the bounds of reasonableness, even if it turns out not to have led to the best possible outcome. As we have previously stated, the action selected should logically be expected, at the time the decision is made, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices."

DRA does not expect each utility to prove that its decision making process and actions resulted in the lowest possible cost. However, DRA strongly believes that this standard does require that each utility prove that it vigorously pursued every alternative that could possibly have been undertaken. Given these investigative proceedings, there is no excuse for expecting less from the utilities. DRA recommends that as a prerequisite for prefunding PBOPs each applicant must present a comprehensive analysis evidencing that its prefunding selection and amount is the best alternative of all known and reasonable courses of action.

B. Alternate Funding Vehicles: Description and Discussion

1) Voluntary Employee Benefit Association Trust (VEBAs)

VEBAs are classified as organizations exempt from income tax under Section 501(c)(9) of the Internal Revenue Code subject to certain requirements. VEBAs must be based on voluntary membership, and the purpose is solely to provide payment of life, sickness, accident and other benefits to eligible participants.

The VEBA trust can be either collectively or non-collectively bargained. Under the current statutes (IRC § 419A (f)(5)), there is no contribution limit for a collectively

bargained trust. Therefore, DRA recommends that collectively bargained VEBA trusts be adopted for funding PBOPs. However, with a non-collectively bargained VEBA trust there are severe restrictions on funding PBOPs which make them much less attractive than collectively bargained VEBAs. These restrictions include the following:

1. **Earnings on contributions to a VEBA trust generally are not taxable** (Internal Revenue Regulation (IRR) § 1.512(a)-5T A-3 and 1.512(b)-1(a)). However, any dividends, interest, and annuities derived in connection with debt-financed property and controlled organizations are considered unrelated business taxable income (IRR 1.512(b)-1(b)) and, as such, constitute taxable earnings. This restricts the types of tax deductible investments which can be used to offset liabilities and, therefore, limits the capacity of the fund to grow.

2. **Pursuant to the enactment of the Tax Reform Act of 1984, the accumulated reserve for post-retirement medical and life insurance (IRC Section 419A(c) (2) (A)) must be reduced each tax year by all payments for post-retirement medical benefits and life insurance benefits (IRC Section 512(3) (E) (ii)).** This may limit the growth of assets.

3. **The amount of the reserve is based on current medical costs (IRC Section 419A(c) (2) (A)); therefore, the reserve ignores medical inflation and results in an underfunding of the liability.**

4. **It is not clear whether prior obligations or only current obligations can be included in the actuarially determined account limit for the reserve.** If only current obligations can be used, and the SFAS No. 106 Transition Obligation cannot be included in determining the contribution limits, then the amount of tax deductible contributions would be severely limited. Last, there is the problem of VEBA PBOPs funds being used for the provision of active employee benefits. For example, funds from the accumulated reserve for postretirement medical costs could be used to create medical facilities that are used by active employees.

As a result, DRA recommends that should noncollectively bargained VEBA trusts be used to fund PBOPs, that certain restrictions be enacted. These restrictions are necessary to protect ratepayers from the risks attendant to contributions which are not in compliance with statutes and to protect the ratepayers' benefits attributable to prefunding under accrual accounting. These restrictions are:

- 1) No rate recovery for investments whose earnings are taxable.
- 2) No rate recovery for the Transition Obligation (SFAS no. 106 paragraphs 247-267), unless applicant submits citations that such prior period obligations are tax deductible.
- 3) Ratepayers must be fully compensated for any PBOPs funding that is transferred or used for anything other than PBOPs.

Some insurance companies are offering trust-owned employee life insurance packages to remedy the limitations of noncollectively bargained VEBAs. These arrangements are a hybrid combination of VEBA trusts with trust-owned life insurance. The contributions to the VEBA trust would be used to pay premiums for retiree life insurance. The proceeds would then be used to fund PBOPs. In addition, the trust could borrow funds to pay for future premiums. The premiums, interest on loans, and earnings on the life insurance reserve are tax deductible. The only drawback is that this funding method is subject to changes in federal and state tax law; therefore, the current tax deductible status may be in jeopardy.

2) 401(h) Account

This account allows pension plans to provide for retiree benefits such as medical expenses if such payment of the benefits are subordinate to the main purpose of the pension plan; contributions and expenses for these benefits are separately accountable; and certain other requirements regarding reversion of funds to the employer and plan termination are met. The test for subordination is based on the contribution amount. The

aggregate of actual contributions made after the date when the plan first included these benefits to provide medical coverage and life insurance protection must not exceed 25 percent of the aggregate contributions unrelated to the funding of prior service costs. Thus, if a plan is fully funded as determined under IRC § 412, then no contributions under IRC § 401(h) are permitted.

DRA recommends that IRC § 401(h) accounts not be used to fund PBOPs unless the respondent utilities can clearly prove that IRC § 401(h) accounts can be modified to preclude reversions or refunds to employers.

3) Annuities

Another option for funding PBOPs is supplemental annuities whereby an employer pays a tax deductible annual premium to a third party insurer and the annuity draws interest tax-free. The risk is then borne by the insurer and not the employer. The payment to employees, however, is taxable.

4) Profit Sharing Plans

Contributions to a trust account, under a profit sharing plan, can be used to provide for an employee's "incidental life or accident or health insurance" (IRC § 1.401-1(b)(1)(ii)). If only life insurance contracts are purchased, then tax-deductible contributions are limited to 50 percent of total payments to a trust account (IRS Revenue Ruling 54-51). For accident and/or health insurance, tax deductions are limited to 25 percent of the total payments to the profit-sharing account. If both life insurance and accident and/or health insurance contracts are purchased, then the amount paid the accident and/or health insurance premiums plus one-half of the amount paid for the life insurance premiums may not, in the aggregate, exceed 25 percent of the funds allocated to an employee's account (IRS Revenue Ruling 61-164, 1961-2 CB 58). Under this method, fund earnings are not taxed and payments to beneficiaries are not taxed to the extent they are vested.

5) Company-Owned Life Insurance

COLI is employee life insurance purchased by the employer. The employer is owner and beneficiary of the policies and the proceeds of the policies are general corporate funds. This means that the employer insures the lives of its employees and the employer receives the proceeds upon the death of the employee. For funding PBOPs, the proceeds can be placed into a health benefit fund earmarked for PBOPs. Under this arrangement, the insurance premiums cannot be deducted for income tax purposes, but the fund's earnings and the payment of proceeds for PBOPs are not taxable. This option is not cost effective because of the nontax-deductibility of the initial premium contributions. Regulated utilities would require a "gross-up" factor to compensate for taxes in arriving at revenue requirements.

There is an alternative arrangement. The COLI can be leveraged by allowing the employer to borrow the cash value (up to \$50,000 coverage per insured individual) to make premium payments in future years. Under this arrangement, the employer can claim a deduction for interest on the borrowing. However, this vehicle is risky because it is very sensitive to changes in tax laws and regulations. For example, it is not clear under California tax law whether the employer has an insurable interest in its employees; therefore, COLI borrowed funds may be subject to the California excise tax.

For these reasons, DRA does not consider any form of COLI to be acceptable for ratemaking purposes.

6) Pension Plans Surplus Assets

Retiree benefits may be funded by using the excess assets of an overfunded pension plan under the 1990 Budget Reconciliation Act. This new rule, effective in 1991, allows a limited amount of excess plan assets to be transferred from the pension plan to the separate retiree medical accounts. One transfer per year from the pension plan is permitted, and there are other limits on the amount of the transfer.

Earnings on assets transferred under this new provision can accumulate tax-free. Furthermore, these noncash benefits are not taxable to retirees. In addition, if an employer transfers excess plan assets to the separate health benefit accounts (i.e., 401(h)), then this amount is not subject to income tax or to the excise tax as a reversion from a qualified retirement plan. DRA strongly endorses this PBOPs funding method. Unfortunately, transfers are permitted only for years beginning in 1991 through 1995; therefore, utilities must take aggressive action soon to take advantage of this superior funding alternative.

7) Cost-Sharing With Offsetting Increases in Other Forms of Deferred Compensation

Under these arrangements, the PBOPs obligations are shared between employer and employee. This benefits the employer by eliminating or reducing his PBOPs burden by the amount borne by the employee. The employee is better-off because other forms of retiree income are enhanced to offset his cost share and the retiree can now deduct his share of the medical expenses which exceed 7% of adjusted gross income. In addition, the nature of the benefit is changed which can significantly improve employee welfare and the economic efficiency of the benefit promise. However, these PBOPs funding methods depend on the employer's ability to communicate to employees that the money should be used to pay for retiree benefits (e.g., medical and dental).

By providing more freedom and resources for the retiree to allocate income between savings and consumption, the beneficiary can more efficiently satisfy his unique needs and lifestyle than could ever result from an arrangement where the beneficiary has no discretion. For example, if the benefit promise does not involve cost sharing, then the retiree has no choice regarding how the benefit funds are allocated or distributed over time. The benefit funds are strictly limited to medical claims as they are incurred and cannot be applied to what the retiree may actually need at the time. Conversely, if cost sharing is attended by enhanced disposable income, then the beneficiary can decide

whether the benefit funds should be invested, earning additional income for future needs, or spent on current needs. The retiree has the power to satisfy all of his unique needs (e.g., not just medical) in a very direct and efficient manner. Furthermore, if the retiree can earn a better return than the employer, then he has the opportunity to do so. This is the concept underlying Cafeteria and Flexdollar plans. The following paragraphs address specific types of deferred compensation⁴⁰ which can be used to fund PBOPs.

8) IRC 401(k)

The 401(k) plan may be used to set aside nontaxable funds for retiree health benefits. These funds accumulate tax-free earnings and, unlike pensions, the beneficiary has discretion over when and how much income he receives. A 401(k) account may be provided in conjunction with a Cafeteria Plan (IRC § 125 and IRR § 1.125-1).

9) Employee Stock Ownership Plans (ESOPs)

This is another flexible and valuable vehicle for funding retiree health benefits. These funds accumulate tax-free earnings and, unlike pensions, the beneficiary has discretion over when and how much income he receives.

10) Pension Plans - Enhanced Benefits

Pension formulas can also be enhanced to cover PBOPs vis-a-vis cost shifting from employer to employee. Unfortunately, this results in an increased pension obligation. However, utilities

40. It is important to understand that unlike the investment vehicles discussed previously, the assets accumulated in these forms of deferred compensation funds cannot be used to offset SFAS No. 106 liabilities.

that have accumulated significant pension surpluses can use part of the surplus assets to offset this increase in the pension obligation. Thus, the PBOPs obligation can be funded without any increase in revenue requirements.

11) Alternative Means for Reducing PBOPs Revenue Requirements

In addition to these funding vehicles, there are other alternative means for reducing the PBOPs revenue requirement. These are:

- a) **Health Cost Containment:** Applicants must submit verifiable proof that they have effective health cost containment programs in place. This could include restructuring the way the benefit is provided by giving the employers more control over what prices are charged. Examples of this restructuring are the establishment of health maintenance organizations and preferred provider organizations whereby the employer has a direct role in the drafting of the insurance contracts and the price schedules for medical procedures and services.
- b) **Cost Shifting from Employer to Employee:** Employees should assume more economic responsibility for their decisions, thereby instituting market forces into utilization and provision of benefits. This can be implemented by increasing or imposing retiree contribution levels or retiree deductibles and coinsurance levels. The net result is a lower portion of the cost is absorbed by the employer. A second alternative would be to require active employee contributions for prefunding their PBOPs. A third example would be to eliminate or substantially reduce the employer's share of the cost by increasing participation in other retirement

plans (e.g., ESOPs, pension plans), thereby, enabling retirees to pick up a greater cost burden.

- c) **Restructuring the Benefit Promise:** Defined contribution plans for retiree health are similar to defined contribution plans for pensions whereby the employer allocates a specified amount to each employee's account and may also involve relinquishing the investment decisions to the employees through investment options available in the market. If the defined contribution plan includes a transfer of investment decisions to employees, then the employee is responsible for using that money to purchase health insurance after retirement. Furthermore, under such arrangements, the contributions may or may not be taxable income to the employee depending on how and if they choose to invest, individually or as a nonbusiness organization. In any case, contributions are tax deductible for the employer. By definition, the employer has no SFAS No. 106 liability beyond the annual contribution, even though the money may not cover the entire amount of health insurance costs incurred during retirement.

There are two other examples of restructuring the benefit promise. The first is by changing the coordination with other plans, such as Medicare payments and payments by other employers. The second alternative is to lower the allowable claims and related reimbursement amounts. For example, the employer could use a fixed schedule of allowable claim amounts for particular services rather than automatically recognizing the increases in inflation.

Participation rights refer to the employer purchasing a participating insurance contract as a means of settlement of a postretirement benefit

obligation. The only difference between the cost of a non-participating insurance contract and a participating contract is the cost of the participation right. According to SFAS No. 106, the cost of the participation right shall be recognized at the date of purchase as an asset. Employer contributions are tax deductible.

Participating contracts have some of the characteristics of an investment. However, the employer is as fully relieved of the obligation as with a non-participating contract. Thus, in both instances the insurance company is incurring the risk of the postretirement obligation. Employer contributions are tax deductible.

Eliminating Coverage includes eliminating dental or vision care for retirees and imposing limits on such things as psychiatric care. The employer could also eliminate coverage for future employees, whereby after a certain date, no or reduced retiree medical benefits are provided.

Eligibility Requirements could be extended by the employer. Under this restructuring, the company requires longer periods of service before employees are entitled to receive PBOPs and reduces the benefits for retirees with a shorter length of service.

C. Utilities Have Not Seriously Considered Cost Shifting

Cost shifting of health care costs should be fully attempted as part of labor negotiations, in order to alleviate some of the cost burden from the employer to the employee. Although it may not be possible to predict with certainty the outcome of labor negotiations, this should not prohibit the utilities from pursuing this as a viable means of controlling the utilities' rising health care cost burden.

As the price of supplying health care increases, so does the market pressure on employees to assume some of the economic responsibility for these benefits. It is unreasonable for a company to always assume, a priori, that labor negotiations would be unfavorable if attempts are made to shift the cost burden to employees. Utilities may be able to negotiate additional cost shifting from the current situation in light of the long-term situation of increasing costs and the fact that utilities and other companies cannot and have not provided 100 percent coverage. More importantly, it is not credible, from the standpoint of a company's bargaining strategy, to assume that employees are always entitled to a benefit regardless of its cost and irrespective of the employees' contribution to the marginal revenue product (i.e., the employee productivity). It makes much more sense to survey the labor market to determine what the prevailing employee benefit levels are. Armed with this information on what the labor market will bear, the employer can develop offers to exchange increases in labor costs for increase in labor productivity. In this way the employer can ensure a quality labor force and attract and retain productive employees.

D. Telecommunication Utilities Have Not Thoroughly Addressed Pension Surpluses

In the Omnibus Budget Reconciliation Act of 1990 (OBRA '90), Congress allowed a transfer of surplus assets from a pension plan to fund separate health benefit accounts once a year for five years beginning in 1991. Although the telecommunication utilities have overfunded pension plans, they have not fully analyzed the viability of using this PBOPs funding method. DRA is concerned that a viable and efficient source of PBOPs funding is being dismissed without sound basis.

More specifically, GTEC pointed out three concerns from their perspective as far as transferring pension assets (GTEC Testimony, page 30). Pacific Bell made similar assertions critiquing transfers of surplus pension assets. However, neither utility provided any substantial evidence such as citation from the tax code and an actuarial study on the actual effect of

transferring pension assets towards funding postretirement benefits. Thus, although this means of funding may involve some complexities, it has not been shown that such phenomena actually exist or make these transfers uneconomic.

DRA is convinced that surplus pension assets transfers should be analyzed and supported with citations and calculations as to whether or not it can be used as a funding source. DRA has submitted data requests requiring such evidence from Pacific Bell and GTEC.

**E. No Utility Has Addressed The Issue Of The
Tax-Deductibility Of The SFAS No. 106
Transition Obligation**

No respondent utility has provided any citations or documentation from the IRS regarding the tax deductibility of the SFAS No. 106 Transition Obligation. If this Commission is to be fully informed on the tax-deductibility issue when determining revenue requirements, then such supporting documentation must be made part of the record.

**F. Utilities Have Not Demonstrated That Nontax-
Deductible Funding Is Cost Effective**

Net present value analyses sponsored by the Saloman Brothers (See DRA Phase II Comments Appendix 3) conclusively show that nontax-deductible funding is uneconomic and is significantly more costly than tax-deductible funding or pay-as-you-go funding. Respondent utilities have absolutely failed to provide any evidence to the contrary. In the absence of any concrete evidence that nontax-deductible funding is cost effective or being used by nonregulated businesses to fund PBOPs, DRA strongly urges the Commission to reject nontax-deductible funding for ratemaking purposes.

7. Safeguards And Incentives For Utilities To Engage In Good Faith Negotiations With Unions To Protect Ratepayers' Interests And Minimize Rateshocks

Regulators are prohibited under the National Labor Relations Act and by court decisions from prescribing outcomes for collectively bargained agreements (Southwestern Bell vs. Arkansas Public Service Commission, July 18, 1986, LR-C-85-832, in U.S. Court of Appeals 824 F2d 672). However, it is well established that this Commission is not obliged to pass-on the resultant costs of any collective bargaining agreement, especially if it is found to be unfair or unreasonable. This means that utility management and labor are free to negotiate or otherwise agree to any compensation levels or arrangements; however, there is definitely no regulatory assurance that unfair or unreasonable arrangements will receive rate recovery.

As with other revenue requirements, standard regulatory review of PBOPs in general rate case proceedings will be one means for ensuring that ratepayers' interests are protected and that rateshock is minimized. Unfortunately, the volatility of the SFAS No. 106 estimates of the PBOPs expenses, especially for retiree medical, may result in dramatic rate fluctuations. This volatility is attributable to instability in medical inflation, changes in plan design and coverage, and to the instability of the interest rate assumptions. It may not be advisable for this Commission to impose a third layer of accounting to ameliorate this volatility because it will further complicate compliance with IRS/ERISA statutes. In addition, there is nothing to prevent labor/management from conducting labor negotiations between test years in order to maximize excess funding. Therefore, DRA concludes that SFAS No. 106 may result in the abuse of ratepayers' money.

DRA strongly believes that the safeguards and prefunding prerequisites it recommends in Phase II Issues Sections 4 (above) and 8 (below) are critical for protecting ratepayers. However, if this Commission authorizes rate recovery too quickly and generously, then there is a real danger of ratepayer shock. To

protect ratepayers from this, rate must be authorized on a case-by-case basis (e.g., in general rate case proceedings and not this OII) and cross-sectional surveys of pension and benefit compensation should be undertaken. These surveys would be used to determine how equitable and competitive employee compensation in regulated utilities is relative to its labor market.

DRA is very concerned that SFAS No. 106 will necessarily result in rateshock and rate volatility (see footnote 9). Therefore, DRA recommends that SFAS No. 106 not be adopted for ratemaking purposes.

8. Monitoring Procedures To Track Plan Activities And Performance

First, DRA requires access to official actuarial reports and analysis on a regular basis, in order to conduct discovery on a timely basis. The importance of reviewing the official actuarial report is that it contains an attestation by a certified actuary as to compliance with the IRS and ERISA statutes and reporting requirements in his/her determination of funding amounts and limits. Without this information, DRA is severely handicapped in trying to conduct a thorough review and analysis of the utility's PBOPs plan. It is crucial to understand that DRA does not have access to the data and resources needed to develop reliable and accurate actuarial valuations. DRA also requires that the actuary identify funding vehicles and amounts, changes in legislation and plans and their effect. This would not be an additional regulatory burden, since the information is part of SFAS No. 106 and most IRS/ERISA disclosure requirements. These requirements include rate of return, descriptions of assets, liability amounts, and disclosure of any changes (e.g. legislative and benefit plan) which are all necessary to track plan activity. This information would avail DRA of the information necessary to determining a fair and reasonable PBOPs revenue requirement.

Second, DRA recommends segregated accounting and reporting for regulated and nonregulated operations. This includes establishing and maintaining separate trusts and accounts for

PBOPs operations. This accounting treatment is necessary for ascertaining whether or not any transfers of assets from regulated to nonregulated operations have taken place.

Third, DRA recommends segregated accounting for active and retiree benefits and prefunding. This would enable DRA to determine whether or not PBOPs revenue requirements are being diverted to nonPBOPs uses.

Fourth, the utilities should report to CACD and DRA any changes in plan design and coverage affecting their PBOPs plan. This is necessary in order to effectively analyze each utility's PBOPs plan and to protect ratepayers' interests.

Fifth, the utilities should report to CACD and DRA any changes in legislation affecting their unique PBOPs arrangements. The Commission needs to be cognizant of changes and how they affect the PBOPs plan activity. Certain legislative and accounting changes may require Z factor treatment for telecommunications utilities or a generic investigation.

Last, to protect ratepayer funds, DRA recommends that utilities be ordered to establish separate accounts to record the amount of rate recovery authorized by this Commission. This accounting would facilitate the monitoring of PBOPs funding by permitting regulators to measure the volatility of revenue requirements over time and the efficiency of rate recovery. This is already required under SFAS No. 71; however, it is DRA's experience that utilities are not reporting these amounts for pensions.

9. Z Factor Treatment For Telecommunications Utilities

DRA believes that the adoption of SFAS No. 106 for ratemaking purposes is inappropriate. Should the Commission agree with DRA, then the rate relief requested by Pacific and GTEC in their Phase II filings should be denied because no regulatory accounting change has been imposed.

If the Commission were to adopt SFAS No. 106 for ratemaking purposes, then Pacific and GTEC should still not be allowed to raise their rates via a Z factor adjustment as both utilities

have proposed. DRA also recommends that neither utility be allowed to recover the prefunding expenses which the Commission found reasonable in Phase I of this proceeding, since those expenses, along with the rest of the SFAS No. 106-related revenue requirement, do not satisfy the Z factor criteria.

A. Summary of DRA's Z Factor Argument

The New Regulatory Framework (NRF) placed on the shoulders of Pacific's and GTEC's management the responsibility to control their expenses and assume more risks in exchange for simplified regulation and the opportunity to earn higher rates of return. DRA believes that to grant Pacific and GTEC any revenue requirement recovery for PBOPs-related expenses via a Z factor adjustment would violate the goals of NRF. More specifically, Pacific and GTEC should not receive any revenue requirement increases as a result of the change in PBOPs funding for the following reasons:

1. SFAS No. 106 is not appropriate for ratemaking purposes.
2. SFAS No. 106 constitutes a change in accounting for PBOPs only, not a change in economic costs.
3. There is no net ratepayer benefit that DRA can determine even if the analysis is extended 25 years into the future. If any benefit did exist, it would be highly uncertain for it would depend on medical and other cost assumptions which would be highly volatile.
4. Pacific and GTEC did not meet their burden of proof for Z factor treatment required by the Commission in D.91-07-006.
5. SFAS No. 106-related costs do not qualify for Z factor treatment under the Commission's NRF guidelines.

**B. Pacific and GTEC Have Not Met Their Burden
of Proving that Rate Recovery is Justified**

The Commission must reject any rate recovery of PBOPs prefunding costs because Pacific and GTEC failed to meet their burden of proof specifically required of them in D.91-07-006:

"In D.89-10-031 we made it clear that to be considered for Z factor treatment, costs must meet the following standards:

1. Costs must be 'clearly beyond the utility's control' (p. 180).
2. Costs must not be 'reflected in the economywide inflation factor' (Conclusion of Law 26).

"...Compliance with those standards will be essential to a finding that Z factor treatment is appropriate. We anticipate that [Pacific's and GTEC's Phase II] testimony will include a discussion of the transition obligation, projected pay-as-you-go costs, projected accrual costs, and how each obligation, cost, or other testimony relevant to the discussion of a Z factor is both beyond utility control and not otherwise captured in the GNPPI. If Pacific Bell and GTEC hope to recover revenues associated with PBOPs costs through a Z factor adjustment, we expect that Pacific Bell and GTEC will make the required showing in its entirety in Phase II." [emphasis added] (pp. 27-28).

Upon analyzing the utilities' testimony, the Commission will find that neither utility addressed in any substantive way the issue of whether PBOPs costs are beyond their control. This lack of showing is in itself sufficient reason for the Commission to deny Z factor treatment since the utilities simply have not met their burden of proof. The Commission must therefore dismiss the revenue requirement increases proposed by Pacific and GTEC.

Although Pacific and GTEC failed to make any meaningful showing regarding the controllability of their PBOPs costs, DRA will demonstrate herein that PBOPs expenses are very much subject to management's control and thus do not warrant Z factor treatment.